The Growth of Carry Over Capital Outlay Authorization in Internal Service Funds

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Executive Summary

Since fiscal year 1999, Utah's Internal Service Funds (ISF) have received authority to acquire nearly $170 million in capital assets. If not used in a given fiscal year, this permission to purchase computer equipment and software, building improvements, vehicles, and other items with an individual value of more than $5,000 – called Authorized Capital Outlay (ACO) – accumulates on agency books, and may be used at any time without further legislative action. For fiscal year 2004, "carry over" Authorized Capital Outlay exceeds $33 million, $6 million more that the amount newly granted for that year.

Because capital purchases made by ISFs are eventually charged to customer agencies' appropriated budgets, the Legislature has set tight controls over these purchases. However, the current practice of allowing unused Authorized Capital Outlay to carry forward unconstrained from year to year creates a potential for diminished legislative control over the ISF rate structure. In the opinion of the Analyst, this should be a concern to the Legislature.

This report examines concerns about the accumulation of unused Internal Service Fund Authorized Capital Outlay by asking the following questions:

- What are Internal Service Funds (ISF)?
- How does budgeting for ISFs differ from budgeting for other entities?
- What is Authorized Capital Outlay?
- How does Authorized Capital Outlay impact ISF budgets?
- How do ISF budgets impact the General Fund and Uniform School Fund?
- What is Carry Over Authorized Capital Outlay?
- How much Carry Over Authorized Capital Outlay exists statewide?
- What can the Legislature do to control capital acquisition while preserving necessary flexibility?

The report concludes that unused Authorized Capital Outlay should not accumulate unchecked, and that the Legislature should treat carry over Authorized Capital Outlay as it does nonlapsing appropriation balances.

What are Internal Service Funds (ISF)?

Internal Service Funds provide goods and services to entities of state government on a cost-reimbursement basis. Properly administered, they take advantage of economies of scale, avoid duplication of effort, and more accurately identify costs of specific governmental services.

An ISF, in conjunction with the Internal Service Fund Rate Committee and the Legislature, establishes its rates to recover the full cost of providing a particular service. Each ISF then bills customer agencies for services rendered by the ISF. Customer agencies therefore have ISF costs built into their operating budgets.

Some agencies maintain their own Internal Service Funds to account for costs for data processing, warehousing, or fleet management. The Department of Administrative Services (DAS) operates a number of state-wide ISFs that provide consolidated services to all state agencies.

Internal Service Funds are governed by explicit rules contained in the Budgetary Procedures Act (See UCA 63-38-3.5). In order to provide accountability, and to ensure proper oversight of the size, mission, and fees charged by ISFs, Utah law imposes the following controls on ISFs:

1. The Legislature must approve all ISF budgets (operating and capital), rates, fees, and other charges.
2. The Legislature must approve the number of full-time equivalent (FTE) positions.
3. **The Legislature must approve capital acquisitions (whether achieved through purchase or transfer).**
4. Working capital must be provided from the following sources in the following order:
    a. operating revenues;
    b. borrowing;
    c. appropriation.
5. An ISF may incur long-term debt (borrowing) from the General Fund as long as:
    a. the debt is repaid over the useful life of the asset; and,
    b. borrowing does not exceed 90% of the net book value of the agency's capital assets.
6. An ISF may add new rates for new services or new products during an interim period, but must have the rates approved by the Legislature during the next general session.

How Does Budgeting for ISFs Differ from Budgeting for Other Entities?

While the Legislature reviews and approves budgets and full-time equivalent (FTE) employment levels for both ISFs and agencies receiving direct appropriations ("appropriated entities"), differences exist in the extent to which ISFs and appropriated entities are bound by legislative action. The following table illustrates some of these differences:

Control Mechanism	Appropriated Entity	Internal Service Fund
Budgets	May not exceed amount appropriated by Legislature (UCA 63-38-3)	May exceed amount appropriated up-to amount collected from other agencies (UCA 63-38a-104)
FTE	May exceed reported value as can be afforded within appropriations.	May not exceed number appropriated by Legislature (63-38-3.5)
Internal Rates	Not applicable	May not increase rates ratified by Legislature. May decrease rates or create new rates for new products without prior legislative approval.
Capital Outlay	May acquire as can be afforded within legislative appropriation	Must be authorized by Legislature
Borrowing from General Fund	Not applicable	May be used for capital acquisition up to 90% of the net book value of an agency's assets

In short, budgets control the size and scope of appropriated agencies. They are only estimates for Internal Service Funds. ISF size and scope is controlled by employment caps (i.e., FTE), rates charged to user agencies, and capital outlay authorization.

What is Authorized Capital Outlay?

As noted earlier, Internal Service Funds must receive permission from the Legislature before acquiring capital assets. This permission is generally referred to as Authorized Capital Outlay. It is granted by the Legislature via appropriations acts.

Once granted, ISFs may acquire capital assets, with a value of over $5,000 apiece, up to the total amount authorized. Authorized Capital Outlay itself is not money – only permission. In order to acquire the asset, ISFs must first have authority, but then must use operating revenue, borrowing from the general fund, or direct appropriations, in that order, to buy assets.

As noted, unlike appropriated agencies, ISFs may borrow from the General Fund, use the borrowing to acquire assets, and then depreciate the asset, repaying the General Fund over a given period of time.

How does Authorized Capital Outlay Impact ISF budgets?

In most cases, Internal Service Funds depreciate capital over a period of three to five years (seven years for fleet vehicles). The annual depreciation of accumulated capital assets appears on ISF financial statements as an expense. This expense is included in the ISF's operating budget.

Therefore, Authorized Capital Outlay impacts ISF spending by driving depreciation expenses, which in-turn drive operating budgets:

ACO → Depreciation → ISF Operating Budget

How Do ISF Budgets Impact the General Fund and Uniform School Fund?

By law, an ISF's budget must be covered by a revenue source, usually rates charged to ISF customers. Rates are calculated by an ISF based upon historical and projected future costs, then approved by an Internal Service Fund Rate Committee, and authorized by the Legislature.

ACO → Depreciation → ISF Operating Budget → Rates

The revenue associated with depreciation expense can be used by ISFs in a number of ways. It is first used to repay General Fund debt. It may be used to acquire new assets. Or, it may accumulate as working capital for future acquisitions.

The user rates with which ISFs recoup expenses, including depreciation, are paid in large part by appropriated entities. Agencies receiving tax dollars from the Legislature use that revenue to pay ISFs for goods or services the agencies consume.

Historically, when Internal Service Fund rates change, the Legislature provides a positive or negative appropriation to user agencies to cover the rate change.

ACO → Depreciation → ISF Operating Budget → Rates → GF/USF

General Fund and School Fund appropriations for Internal Service Fund rate changes historically have been pro-rated based upon the proportion of tax funds in an entity's total budget. On average, the General Fund and Uniform School Fund make up 47% of Utah's total budget.

The following example illustrates how authorized capital outlay impacts General Fund/School Fund appropriations:

The Division of Information Technology Services (ITS) seeks to improve its statewide communications network. To do so, it needs to install new transmitter towers, radio shacks, and radio equipment on mountain tops throughout the state. To acquire this capital, ITS first obtains permission – Authorized Capital Outlay – from the Legislature. Next, ITS uses its operating revenue, or borrows money from the General Fund, to purchase the capital. After installing the capital, ITS uses the total cost of the capital and its useful life to establish an annual depreciation expense. Retired capital is removed, and depreciation ends. ITS includes any additional annual depreciation expense in its overall annual budget for communications. It uses this budget change, and an historic level of consumption, to calculate changes to its rates. After receiving Rate Committee and Legislative approval, ITS charges the increased rates to state agencies. The agencies and Governor's Office of Planning and Budget ask the Legislature to increase General Fund appropriation to cover the increased cost of ITS Wide Area Network charges.[1]

What is Carry Over Authorized Capital Outlay?

The Budgetary Procedures Act stipulates that the Legislature must approve Internal Service Fund capital outlay. The Act does not state what happens to that approval should an ISF fail to exercise it in a given fiscal year. By administrative practice, Internal Service Funds have accumulated the unused approval from year-to-year – calling it Carry Over Authorized Capital Outlay.

According to Executive Branch officials, agencies, the Division of Finance and Governor's Office of Planning and Budget have tracked this carry-over for many years. Agencies began reporting this balance to the Legislature on ISF financial forms beginning with the 2003 General Session.

Elaborating on the example above, if the Division of Information Technology Services had requested $5 million in Authorized Capital Outlay for its towers, shacks, and radios, and acquired only $4 million in a given year, it would have "carried over" the remaining $1 million into the next fiscal year, adding it to amounts left over from previous years, and reporting it to various oversight entities.

In general, capital outlay authorization has in the past exceeded actual acquisition, resulting in large positive carry over balance.

There is at least one case, however, in which an ISF exercised carry over authority to make acquisitions that had not recently been reviewed by the Legislature. As shown in the figure below, the Division of Information Technology Services acquired $10 million in capital assets in FY 2001, at least $3.9 million (39%) of it using Carry Over Capital Outlay Authority.[2]

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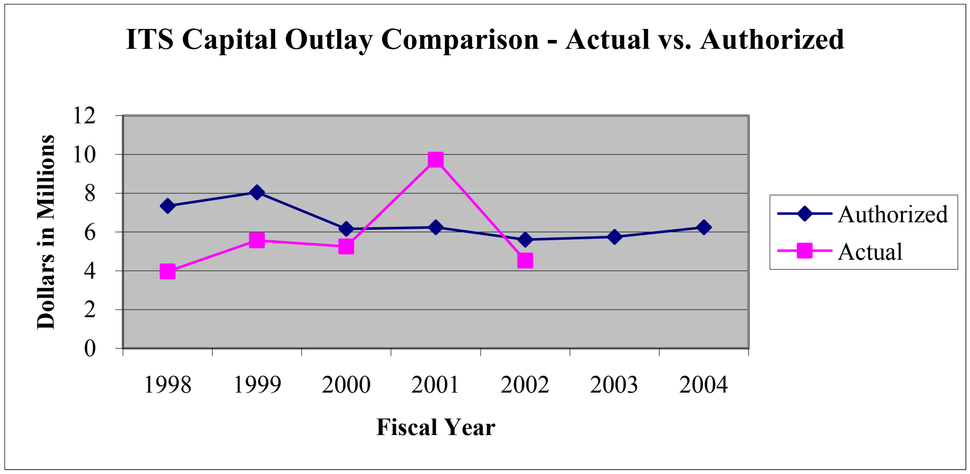
[1] The authors focus here upon tax revenue for the purpose of demonstrating the impact of authorized capital outlay upon the General Fund. Agencies also request appropriations from other sources to cover rate changes, usually proportionally based upon historical funding mix.

[2] An accounting change regarding the treatment of software resulted in about $2 million of this difference.



It may be the case that agencies exercise prior year authority when revenues are rich. In the ITS case, a prior year rate increase left the agency flush with cash or cash equivalent retained earnings. While ITS did lower rates that year, the rate decrease was not as large as it would have been had ITS not exercised Carry Over Authorized Capital Outlay. And, as the new capital is depreciated over a number of years, the additional capital acquisition impacted rates, and thus agency General Fund spending, for years into the future.

How Much Carry Over Authorized Capital Outlay Exists Statewide?

In FY 2004, Utah's Internal Service Funds will start the year with permission to purchase more than $64 million in capital assets. Of that amount, $33 million was carried over from previous years. The following table details Authorized Capital Outlay by Internal Service Fund and year.

Internal Service Fund Capital Outlay

Authorized	**2000**	**2001**	**2002**	**2003**	**2004**
General Services - State Mail	120,000	120,000	140,000	160,000	92,000
General Services - Other	1,714,500	1,583,000	3,139,000	3,554,000	2,285,900
Fleet Operations - Administration	0	0	0	0	6,000
Fleet Operations - Federal Surplus	0	0	0	0	0
Fleet Operations - State Surplus	0	0	0	0	106,100
Fleet Operations - Motor Pool[1]	44,712,400	21,530,400	16,090,800	20,662,800	17,948,600
Fleet Operations - Fuel Network	110,000	215,000	115,000	0	275,000
Facilities Construction and Management	106,000	35,000	80,000	0	11,500
Information Technology Services	6,164,000	6,243,600	5,604,700	5,745,800	5,732,800
Risk Management	0	50,000	50,000	0	12,000
Department of Natural Resources	2,148,000	750,000	100,000	100,000	100,000
Department of Agriculture	30,800	38,000	58,000	59,600	22,000
Department of Human Services	0	0	0	0	0
Department of Corrections	226,400	497,300	417,000	442,000	429,500
Total	$55,332,100	$31,062,300	$25,794,500	$30,724,200	$27,021,400

Actual/Estimated	**2000**	**2001**	**2002**	**2003**	**2004**
General Services - State Mail	142,400	182,700	5,800	300,000	92,000
General Services - Publishing	1,428,100	1,449,800	1,059,200	5,280,100	2,285,900
Fleet Operations - Administration	5,500	20,500	0	0	6,000
Fleet Operations - Federal Surplus	46,200	8,700	0	0	0
Fleet Operations - State Surplus	186,800	11,700	0	0	0
Fleet Operations - Motor Pool	33,484,700	20,066,800	16,792,000	17,654,900	17,948,600
Fleet Operations - Fuel Network	1,137,500	20,100	17,600	0	275,000
Facilities Construction and Management	38,300	12,500	93,700	93,000	11,500
Information Technology Services	5,247,200	10,141,500	4,680,000	5,745,800	6,245,800
Risk Management	7,800	12,800	104,700	0	12,000
Department of Natural Resources	36,900	0	0	100,000	100,000
Department of Agriculture	30,100	0	0	59,600	22,000
Department of Human Services	0	5,400	0	0	0
Department of Corrections	254,500	355,000	104,600	216,000	429,500
Total	$42,046,000	$32,287,500	$22,857,600	$29,449,400	$27,428,300

Lapsed By Intent[2]	**2000**	**2001**	**2002**	**2003**	**2004**
Information Technology Services	0	0	0	2,510,200	0
Total	$0	$0	$0	$2,510,200	$0

Carry Over	**2000**	**2001**	**2002**	**2003**	**2004**
General Services - State Mail	1,167,300	1,144,900	1,082,200	1,216,300	1,076,300
General Services - Publishing	1,945,600	2,232,000	2,365,300	4,495,100	2,769,000
Fleet Operations - Administration	(6,400)	(11,900)	(32,400)	(32,400)	(32,400)
Fleet Operations - Federal Surplus	164,000	117,800	109,000	109,000	109,000
Fleet Operations - State Surplus	304,600	117,800	106,100	106,100	106,100
Fleet Operations - Motor Pool	4,179,000	15,406,700	16,870,300	16,169,000	19,176,900
Fleet Operations - Fuel Network	2,158,100	1,130,600	1,325,500	1,422,900	1,422,900
Facilities Construction and Management	43,100	110,800	133,200	119,500	26,500
Information Technology Services	8,474,400	9,391,200	5,493,300	6,418,000	4,473,000
Risk Management	214,700	206,900	244,100	189,400	189,400
Department of Natural Resources[3]	4,436,000	6,547,100	1,915,100	2,015,100	2,015,100
Department of Agriculture	0	0	0	0	0
Department of Human Services	588,200	588,200	582,800	582,800	582,800
Department of Corrections	734,900	706,800	849,100	1,161,500	1,387,500
Total	$24,403,500	$37,688,900	$31,043,600	$33,972,300	$33,302,100

1. FY 2000 includes $19 m in vehicles transferred to Fleet Operations by other agencies under UCA 63-38-3.5(8)(f)(ii).
2. Fleet agreed to lapse all of its carry over authority on June 30, 2003. This agreement was not reflected in intent language.
3. DNR administratively lapsed carry over authority in FY 2002.

What can the Legislature do to control capital acquisition while preserving necessary flexibility?

The fact that carry over authority can span multiple years, and that FY 2004 carry over authority exceeds current year authority are areas of concern to the Legislative Fiscal Analyst.

Under current practice, an ISF could use in one year authority it accumulated over a number of prior years. As noted before, in FY 2001, the Division of Information Technology Services exercised nearly $4 million in carry over authority.[3] ITS had accumulated only $917,000 the year before, thus it may have been using authority that was two years old or older.

As legislative committee make-up changes every two years, it may be prudent to have legislators review planned acquisitions using carry over authority on an annual basis. In appropriated agencies, statute currently requires the Legislature to approve projects upon which nonlapsing appropriations will be spent. This type of procedure would also work for Internal Service Funds.

Also of concern to the Analyst is the FY 2004 amount of Carry Over Capital Outlay Authority. As noted earlier, given sufficient operating revenue, or using General Fund borrowing, an ISF may use this authority without further legislative action. Doing so would probably result in a need to raise rates or would negate potential savings.

These issues were addressed by the Capital Facilities and Administrative Services Appropriations Subcommittee during the 2003 General Session, but only for the Division of Information Technology Services, and without statutory direction. The subcommittee's action resulted in a $2.5 million reduction in ITS' carry over authorization, as well as a schedule of projects upon which remaining carry over authorization will be used.

Recommendations

The Analyst recommends amending the Budgetary Procedures Act to clarify that:

1. Unless explicitly granted by the Legislature, ISFs do not have authority to carry over Authorized Capital Outlay.
2. The ISF must have legislative approval in the Appropriations Act for items to be acquired using Carry Over Authorized Capital Outlay. This would be similar to the way in which the Legislature currently grants nonlapsing status for specific projects in appropriated agencies (see UCA 63-38-8.1).

[3] An accounting change regarding the treatment of software resulted in about $2 million of this difference.